

BEFORE THE
Federal Communications Commission
WASHINGTON, D.C.

MAY 31 1996

In the Matter of

Allocation of Costs Associated with
Local Exchange Carrier Provision of
Video Programming Services

CC Docket No. 96-112

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SUMMARY

NCTA strongly supports the Commission's proposals in the Notice to allocate common costs on the basis of fixed factors and, informed by the attached economic analysis of Dr. Leland Johnson, recommends allocating 25% of common costs to regulated telephony and 75% of common costs to video transmission. The use of fixed factors to allocate common costs will achieve the Commission's goal of adopting a process which is administratively simple; adapts to evolving technologies; permits uniform application among incumbent LECs; and is consistent, to the extent possible, with principles of cost causation. Further, the use of fixed factors to allocate common costs will enable the Commission to achieve the important policy goal of preserving universal telephone service. The Commission should adopt effective cost allocation rules before the issuance of OVS certificates.

Consistent with the Commission's stated goals, the costs of spare facilities should be allocated on the basis of cost causation. Local telephone companies appear to have constructed substantial excess capacity in anticipation of offering video transmission and other services unrelated to the provision of local telephone service; the costs of excess capacity should not be borne by telephone ratepayers. Instead, these costs should be borne by customers of the new service or telephone company shareholders. Price cap indices should be reduced accordingly.

In a similar effort to protect local telephone ratepayers, the 1996 Act's imputation requirements for pole attachments, conduits and related items should be reflected in reduced local telephone rates.

Finally, the scope economies resulting from network integration should accrue primarily to local telephone ratepayers. Through decades of monopoly local exchange service,

local telephone ratepayers have underwritten the research and development enabling the creation of a valuable backbone network which will be used in the future to provide not only telephone services but also video services. Consistent with the principle that incumbent LEC rates should be based on forward-looking costs, in recognition of past ratepayer contributions, and to further protect against cross-subsidization of telephone company provision of competitive video services, a significant portion of the gains derived from scope economies should be shared with local telephone ratepayers through a reduction in price cap indices.

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COMMENTS OF THE NATIONAL CABLE TELEVISION ASSOCIATION, INC.

The National Cable Television Association, Inc. ("NCTA"), by its attorneys,
hereby files its comments in response to the Commission's Notice of Proposed Rulemaking
("Notice") in the above-captioned proceeding.¹

I. INTRODUCTION

NCTA fully endorses the Commission's conclusion that the existing cost allocation
regulations are inadequate in an era of integrated telecommunications networks. The
Commission's action is necessary in light of the 1996 Act's requirement that "a
telecommunications carrier may not use services that are not competitive to subsidize services that
are competitive."²

¹ See Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services, FCC No. 96-214 (released May 10, 1996) ("Cost Allocation Notice" or "Notice")

² 47 U.S.C. § 254(k).

II. THE COMMISSION PROPERLY CONCLUDES THAT EXISTING REGULATIONS ARE INADEQUATE AND NEW PROCEDURES ARE NECESSARY.

As long ago as its initial Notice of Inquiry in the VDT proceeding,³ the Commission acknowledged that "telephone companies potentially could engage in anticompetitive conduct . . . by imposing added costs on the monopoly ratepayer by cross-subsidizing such new broadband services."⁴ Desiring that this risk not become a reality, NCTA has consistently called for the establishment of a comprehensive policy for allocating the costs of integrated facilities.⁵ Although the Commission declined to adopt a comprehensive video/telephone cost allocation policy for the development of integrated networks in the course of the VDT proceedings, the record before the Commission on VDT strongly supports the conclusion in this Notice. The conclusion in this Notice -- that the existing rules are inadequate and cross-subsidization is a real concern -- is exactly correct.

As the Notice recognizes, the existing cost allocation rules "were not designed" for integrated networks offering both regulated and non-regulated transmission services.⁶

³ See Telephone Company-Cable Television Cross-Ownership Rules, Notice of Proposed Rulemaking, 2 F.C.C.R. 5092 (1987).

⁴ Id. at 5093.

⁵ See, e.g., Joint Petition of the Consumer Federation of America and the National Cable Television Association for Rulemaking and Request for Establishment of a Joint Board, 8 F.C.C.R. 2919 (1993).

⁶ Cost Allocation Notice, at 3, ¶ 2.

A. The Commission Should Expeditiously Establish Clear, Well Defined Cost Allocation Rules.

In the era of separate entities offering video and telephony over completely different networks, the Commission's current cost allocation rules might have been more appropriate. However, a changing environment requires a different regulatory approach.

In the course of the Video Dialtone proceedings, the Commission repeatedly postponed addressing cost allocation issues. The Commission is correct to avoid that approach here. Delaying the cost allocation issue indefinitely fails to provide carriers a useful model for the calculation of investment recovery. Rather, defined rules outlining the process of allocating integrated network costs are necessary if incumbent LECs are to make rational investment decisions.

B. The Commission Should Establish Cost Allocation Rules Before Certifying Carriers to Construct Open Video Systems.

It is imperative that the Commission define its cost allocation rules before certifying carriers to provide Open Video Systems. The construction of Open Video Systems will be costly. Without cost allocation rules and related expectations with respect to pricing, the FCC will have to play "catch-up."

The risks associated with speculative LEC investments are borne in material part by telephone ratepayers. Although the 1996 Act and the Commission have taken several measures to promote local exchange competition, no adequate alternative to the incumbent LECs currently exists to provide local telephone service. Until effective competition in the local exchange can develop, the quality and universal availability of local telephone service depends upon the incumbent LECs. Unfortunately, today and for the foreseeable future, captive telephone

ratepayers unavoidably run the risk of underwriting inappropriately allocated LEC OVS investments.

III. COMMON COSTS SHOULD BE ALLOCATED ON THE BASIS OF FIXED FACTORS.

This proceeding is made necessary by the passage of the 1996 Act. The 1996 Act authorizes telephone companies to provide video programming directly to subscribers, and establishes Open Video System (OVS) service as a means by which local exchange carriers may deliver video programming without obtaining a cable franchise.

The Commission explains:

The basic problem addressed in this proceeding is how to allocate common costs between the nonregulated offerings that will be introduced by local exchange carriers and the regulated services they already offer. Our current cost allocation rules were not designed for this task.⁷

The purpose of this proceeding is to resolve this "basic problem" by establishing cost allocation procedures "designed for the task" of allocating costs between regulated telephone and nonregulated video facilities. The Commission's existing Joint Cost rules explicitly require that

[i]ncumbent local exchange carriers subject to the cost allocation manual filing requirements must file changes to their manuals whenever the cost apportionment table is changed, 60 days before that change takes effect.⁸

According to the Notice, "[a] decision by a local exchange carrier to offer video programming service on a nonregulated basis will require a change to its apportionment tables."⁹

⁷ Id. at 3, ¶ 2.

⁸ Id. at 9, ¶ 15 (citations omitted); see 47 C.F.R. § 64.903(b).

⁹ Id.

In enacting the Telecommunications Act of 1996, Congress was keenly aware of both the benefits and potential harms posed by increasing telecommunications competition. In order to protect universal service from potential harm, the Act explicitly prohibits the cross-subsidization of competitive services with noncompetitive services and directs the Commission to establish cost allocation rules to prevent this cross-subsidization.¹⁰ The Senate Report contains an enlightening discussion of this provision:

The FCC . . . [is] required to establish any necessary cost allocation rules . . . to ensure that universal service bears no more than a reasonable share (and may bear less than a reasonable share) of the joint and common costs of facilities used to provide both competitive and noncompetitive services. For instance, this provision, at a minimum, prevents any assignment of direct costs associated with the provision of competitive telecommunications services, information services, or video programming services to telephone exchange service or exchange access service, as long as such exchange or exchange access service remains non-competitive.¹¹

The Commission recognizes "the most difficult problem . . . [to be addressed] . . . is how to allocate common costs associated with facilities connecting incumbent local exchange carrier switching facilities with customers' premises."¹² The agency also acknowledges a similar

¹⁰ 47 U.S.C. § 254(k).

¹¹ S. REP. NO. 23, 104th Cong., 1st Sess. 30 (1996); see also S. CONF. REP. NO. 230, 104th Cong., 2d Sess. 134 (1996) ("The House recedes to the Senate with minor technical modifications on new subsection 254(k), which prohibits cross-subsidization and permits the Commission . . . to establish cost allocation rules for facilities used in the provision of services supported through Federal universal support mechanisms.").

¹² Cost Allocation Notice, at 3, ¶ 2; see also Declaration of Dr. Leland Johnson, Nov. 30, 1995, appended to National Cable Television Association Opposition to Direct Case, Amendment to the Bell Atlantic Telephone Companies Tariff FCC No. 10, Nov. 30, 1995.

challenge with respect to the "allocation of common costs of switching equipment and interoffice trunks" as well as to expenses.¹³

NCTA endorses the proposal in the Notice to allocate these common costs between services on the basis of "fixed factors," because it is the most practical means available for achieving efficient allocations. Administrative simplicity is a legitimate objective in light of the costs to the Commission, carriers and competitors of more complex schemes that achieve no apparent comparative benefit. A fixed factor allocation scheme is the best available approach for allocating costs not directly assigned.

A. Loop Plant Should Be Allocated on the Basis of Fixed Factors

1. Direct Assignment

The Commission proposes to establish specific and uniform cost pools and allocation factors by plant categories. With respect to loop plant, it first rejects direct assignment. The Notice explains that "[d]irect assignment is most easily accomplished when accounting or operating records demonstrate that particular facilities or resources are dedicated to regulated or nonregulated activities."¹⁴

Current loop plant can be directly assigned to telephone services, but in the future plant situated between central offices and subscribers will be used to deliver telephone and video services on an integrated basis. It will no longer be possible to directly assign the loop plant exclusively to the telephone service, because the loop plant will no longer be dedicated exclusively to regulated services.

¹³ Id.

¹⁴ Id. at 13, ¶ 28.

2. Usage Based Allocation

Where direct assignment of loop plant is not possible, the Joint Cost rules require the allocation of costs based on "the relative regulated and nonregulated use during the calendar year when nonregulated use is the greatest in comparison to regulated use during a forecasted three-year period."¹⁵ As the Notice recognizes, usage-based cost allocation methods are appropriate for the pricing of traffic sensitive plant. But, "[f]or loop plant, usage-based methods would require the allocation of non-traffic sensitive costs on a traffic sensitive basis."¹⁶ There is no basis for concluding that a usage-based allocator will achieve results that are in any sense related to cost causation, and the burden of implementing such an approach would be enormous.

Network construction is heavily weighted with fixed costs. The costs of the network elements are highly traffic insensitive, as the Commission noted.¹⁷ Notions of relative use will become useless.¹⁸ Robert Pepper of the Commission's Office of Plans and Policy offers this example:

The notion of trying to set prices based on some measure of relative use becomes even more absurd if they are based on a combination of throughput and actual minutes of use patterns -- the average residential telephone is used only about 23 minutes each day while

¹⁵ Id. at 14, ¶ 30, citing 47 C.F.R. § 64.901(b)(4)

¹⁶ Id.

¹⁷ See id., at 10, ¶ 19 ("Because loop plant is primarily traffic insensitive, the usage-based allocation process prescribed by our Part 64 rules does not result in cost-causative allocations.").

¹⁸ See Robert M. Pepper, Through the Looking Glass: Integrated Broadband Networks, Regulatory Policies, and Institutional Change, 4 F.C.C.R. 1306, 1312, ¶ 54 (1988) ("The questions of allocating costs . . . will be . . . difficult in an integrated broadband environment. . . . Historical methods of measuring relative use will become meaningless in such an environment.").

the average television set is on approximately seven hours daily. Thus, if relative use is based on time and throughput, the \$15.00 per month basic video charge would translate into flat rate telephone service of one-tenth of a cent per month.¹⁹

Thus, the Commission is correct in seeking to avoid attempts to allocate these costs based on relative usage.

3. Indirect Analysis

The Commission also seeks comment on a third allocation method in which the agency would develop and apply "a ratio that reflects the extent to which associated loop plant is directly assigned to regulated or nonregulated activities and apply that ratio to loop plant categories of common costs."²⁰ The Notice offers the example that "if 40 percent of directly assigned loop costs are allocated to regulated activities, then 40 percent of the loop costs of associated facilities would be allocated to regulated activities and 60 percent to nonregulated activities."²¹

This allocator would not work because, as the Notice anticipates, the amount of directly assigned loop plant relative to all loop plant would be so small as to make the allocation "unreasonable" and ripe for "manipulation."²² The ratio method should be rejected for the additional reasons that it is unrelated to either cost causation or any articulated policy objective.

¹⁹ Id., at 1313, ¶ 60.

²⁰ Cost Allocation Notice, at 15, ¶ 34.

²¹ Id.

²² Id.

4. Stand-Alone Cost Test

The fourth approach upon which the Commission seeks comment is the establishment of a ceiling on the total loop costs that can be allocated to regulated services. The proposal would be to cap rates at the cost of the stand-alone telephone system, which would in theory prevent telephone ratepayers from bearing any of the additional costs resulting from the construction and operation of the integrated system.

The stand-alone cost test provides an important benchmark, but alone it is not sufficient. A ceiling approach would prevent telephone ratepayers from sharing in any of the economies of integration, and assigning all scope economies to unregulated operations such as video. (If there are no economies of scope from integration, the telephone company will presumably construct stand-alone networks.) It would, moreover, appear to contravene congressional and Commission policy supporting low telephone rates in favor of promoting the telephone companies' unregulated video ventures ²³

5. Fixed Factors

NCTA supports the present process of directly assigning the costs of dedicated network components to the appropriate regulated or non-regulated service. Expenditures clearly undertaken to provide telephone service should be allocated to that service. However, as the Commission noted, integrated networks for the dual provision of telephony and video create

²³ The calculation of stand-alone costs of telephony will, itself, be a contentious and uncertain process. There is no need to create the additional, unnecessary administrative burdens that would inevitably accompany a usage-based method of common cost allocation.

difficulties in allocating common costs to the appropriate services.²⁴ NCTA strongly supports the Commission's tentative conclusion that common costs should be allocated on the basis of a fixed factor approach.²⁵

a. To the extent possible, a fixed factor approach is consistent with principles of cost causation

Because the allocation of common costs is an inevitably somewhat arbitrary process, it is not possible to explicitly base the allocation decision on cost causation. The principle of a cost-causative allocation process provides an efficient outcome because -- assuming prices track costs -- customers will pay for the costs of the services they receive. Further, as the Commission recognized in the Notice, following principles of cost causation minimizes cross-subsidies.²⁶

However, any cost allocation process that attempts to assign common costs cannot avoid an element of arbitrariness. As the Commission states in the Notice, certain costs are "unattributable" and must be "allocated using a prescribed general allocator."²⁷ Stated differently, the allocation of common costs is a result-oriented exercise in the sense that assumptions determine outcomes. There simply is no way to attain a cost causative allocation in the pristine

²⁴ See Cost Allocation Notice, at 10, ¶ 10 ("The basic problem this proceeding must address is how to allocate costs of shared facilities that will be used jointly for regulated and nonregulated activities.").

²⁵ See id., at 17, ¶ 40.

²⁶ See id., at 13, ¶ 25 ("[C]onsistency with economic principles of cost-causation is the most direct means of assuring that telephone ratepayers do not bear the costs and risks of competitive, nonregulated activities.").

²⁷ See id., at 8, ¶ 13.

sense. In consequence, a fixed factor approach derived by reference to policy goals departs no further from cost causation than other available approaches.

b. Administrative simplicity

A fixed factor approach to the allocation of common costs is administratively simple. When telephone companies provide services using integrated networks, the commingled manner in which the services are produced and offered to consumers greatly complicates the cost accounting process.

Little will be gained by going to elaborate lengths to establish a cost allocation that inherently is arbitrary. The administrative complexity of a usage-based method of cost allocation simply has no special benefits that would justify its cost. The Commission's and the public's expenditure of time and resources in cost studies, economic analyses and incessant arguments about appropriate allocation levels in particular circumstances for particular carriers will not produce commensurately better decisions. This can be avoided by allocating common costs on the basis of a fixed factor explicitly designed to produce the Commission's preferred public policy outcomes.

c. Uniform application

The Commission can uniformly apply a fixed factor approach to incumbent LECs. Of course, cost determinants such as population density, terrain and other factors vary widely within and among LEC territories. That does not, however, mean that allocations between regulated and unregulated services should vary substantially.

d. Adaptability to evolving technology

The method of allocating common costs using a fixed factor approach is readily adaptable to evolving or new technologies. The actual percentages used to split costs of

regulated services and nonregulated services may need to be revisited from time to time as technology, consumer demand, and policy goals evolve. As the Commission noted, the stand-alone costs of a state-of-the-art telephone network (one which uses digital loop carriers, for example) are the baseline to determine whether a cross-subsidy is occurring. The stand-alone costs themselves may change as technology develops. By focusing on the stand-alone costs of a state-of-the-art telephone network, the Commission need only focus on the technology involved in providing local telephony as opposed to the costs of the other services which may, in the future, be offered over the integrated broadband networks. Hence, a fixed factor approach easily adapts to enable the Commission to continue its role of protecting local telephone ratepayers.

e. Consistency with Commission policy goals

Utilizing a fixed factor approach enables the Commission to achieve important policy goals of preserving universal access to telephone service. As the Commission recognized in the Notice, because demand for telephone service is highly inelastic, consumers will be vulnerable to telephone rate increases resulting from LEC cross-subsidization of integrated networks to provide video services.

The Commission's method of allocating costs should protect ratepayers from excessive charges and protect universal access to telephone service. A fixed factor approach to cost allocation accomplishes this goal as or more securely than alternatives. By setting the fixed allocation of common costs at a rate that experience suggests would keep regulated costs under the ceiling established by stand-alone costs, the Commission in the general case can feel secure that it has protected ratepayers from excessive charges and competing interests from cross subsidies. Such an allocation in the general case also will serve to share the gains from economies of integration between the regulated entity and ratepayers.

B. Interoffice Transmission and Switching Plant Should Be Allocated Based on Fixed Factors

The benefits of administrative simplicity that use of a fixed factor provides should be extended to the allocation of costs for interoffice transmission and switching plant. As Dr. Johnson concludes, "[t]he extreme difficulty of obtaining such disaggregated data, going beyond local loops [for switching plant and interoffice transmission facilities] . . . suggests that the Commission might do best simply to use the same fixed factor allocations as for local loop investment."²⁸

The Commission correctly notes that "[t]he operation of newer technologies, such as packet switching . . . differ substantially from the more traditional technologies used to transmit information."²⁹ These technological advancements reduce the extent to which switching costs relate to usage. Those switching costs which are non-traffic sensitive will continue to increase in the future as technology develops. The Commission notes that "[i]f switch costs are not traffic sensitive, economic principles of cost causation would appear to support a fixed allocator for switching costs."³⁰ The Commission should take account of the trend toward increasingly non-traffic sensitive switching costs (effected by technological developments) by applying to the common costs of switching the same fixed factor used to allocate the common costs of loop plant.

Similarly, there is no legitimate basis for treating differently interoffice transmission facilities and loop plant for purposes of cost allocation. In light of their similarities, the

²⁸ Leland L. Johnson, Ph.D., Allocating Common Costs to Avoid Cross-Subsidy and Enable the Sharing of Benefits, at 8 [hereinafter "Johnson, Allocating Common Costs"].

²⁹ Cost Allocation Notice, at 18, ¶ 44.

³⁰ Id., at 19, ¶ 44.

Commission historically has applied the same cost allocation treatment to loop plant and interoffice transmission facilities.³¹ Both are non-traffic sensitive and, for the reasons stated above with respect to loop plant, the Commission should apply the same fixed factor to interoffice transmission facilities that it proposes to apply to loop plant.

C. Expenses Should Be Allocated Based on Fixed Factors

The allocation of network-related expenses, maintenance expenses, marketing expenses and overhead should be performed using the same fixed factor applied to loop plant. In its Notice, the Commission tentatively concludes that "the allocation of [network-related] expenses should be based on the network plant allocation."³² In light of the Commission's tentative conclusion, the adoption of the NCTA proposals contained herein, namely the application of a fixed factor to common costs for all network elements, would result in allocating network-related expenses on the basis of the same fixed factors. The considerable administrative efficiencies of this course are self-evident.

Similarly, the Commission also proposes to use some type of fixed factor in applying common costs related to maintenance expenses,³³ marketing expenses³⁴ and overhead.³⁵

³¹ See id., at 19, ¶ 45 ("These [interoffice transmission] facilities receive the same cost allocation treatment as loop plant.").

³² Id., at 20, ¶ 47.

³³ Id., at 20, ¶ 48 ("We tentatively conclude that . . . we should use a fixed factor, and, in particular, the same factor we propose to use to allocate the maintained plant itself.").

³⁴ Id., at 20, ¶ 49.

³⁵ Id., at 20, ¶ 50 ("Where direct or indirect attribution is not possible, our rules require the carriers to allocate overhead expenses . . . based on a general allocator.").

For purposes of ensuring ratepayer protection against cross-subsidization and for administrative ease, NCTA recommends using the same fixed factor used for loop plant for all expense categories.

IV. THE COMMISSION SHOULD ALLOCATE SEVENTY-FIVE PERCENT OF THE COST OF THE PLANT PRICED ON THE BASIS OF FIXED FACTORS TO UNREGULATED VIDEO SERVICES

When a LEC seeks to offer video services, it may build a parallel video network or integrate its existing telephone network to provide video. Either option carries with it the danger of cross-subsidization from regulated telephone service. But, the latter option increases the relative size of the common cost category for providing video and telephone services, thereby making cost allocation more difficult. In the event that the costs of providing video are underallocated, local telephone ratepayers will be forced to subsidize the incumbent LECs' competitive provision of video service. Cross-subsidization artificially inflates local telephone rates and skews the market for providing video services in the LEC's favor.

As Dr. Johnson explains in detail in the attached analysis, the video dialtone experience suggests strongly that a large portion of common costs must be allocated to video services to prevent cross-subsidization.³⁶ Indeed, in some circumstances "even a 100 percent allocation to video would be insufficient to prevent cross-subsidization."³⁷

³⁶ See Johnson, Allocating Common Costs, at 2 ("I conclude that an allocation of more than 50 percent of common cost to video would be warranted.").

³⁷ Id. at 6.

A. The Commission Should Utilize Estimated Costs in Determining the Appropriate Fixed Factor Ratio.

The determination of an appropriate allocation for common costs will necessarily depend upon estimates.³⁸ As noted, the Commission must consider administrative efficiency and public policy goals such as the protection of local telephone ratepayers.³⁹ A search for the precise costs incurred for integrated network construction attributable to video services will prove endlessly time-consuming and ultimately futile. As Professor Hausman suggested on behalf of Bell Atlantic in the Commission's Local Competition Rulemaking,⁴⁰ rather than incurring the considerable administrative costs of the futile search for precise costs, the Commission would be well-advised to adopt a proxy cost model that "provides a safe harbor that . . . parties know is acceptable."⁴¹

Keeping in mind that a properly configured proxy cost model approach can be efficient and beneficial to all parties, NCTA recommends a similar administratively efficient

³⁸ In a recent speech, Dr. Joseph Farrell, the Commission's Chief Economist, noted that "cost allocation is a dark mystery." See Joseph Farrell, Creating Local Competition, (May 15, 1996), in FCC Daily Digest, May 17, 1996, at 553039.

³⁹ See MCI Telecommunications Corp. v. FCC, 675 F.2d 408, 415-416 (D.C. Cir. 1982)("The very problem at issue here -- allocation of common costs -- arises precisely because there is no purely economic method of allocation. In this sense no Commission choice among the various methods could be justified solely on economic criteria; elements of fairness and other noneconomic values inevitably enter the analysis of the choice to be made.").

⁴⁰ Implementation of Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, Notice of Proposed Rulemaking (released April 19, 1996).

⁴¹ See Implementation of Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, Comments of Bell Atlantic, Attachment 1, at 8 (May 16, 1996).

approach here -- allocating 25% of common costs to the provision of regulated telephone service and 75% of common costs to the provision of video services.⁴² To be sure, this formula may, in some cases, slightly over-allocate costs to telephony (and under-allocate to video transmission) in the sense that it may permit assigned costs to exceed the stand-alone ceiling, but NCTA believes that this ratio still serves to generally protect local telephone ratepayers from the negative effects of cross-subsidization.

Further, the fixed allocation method is warranted not only in the case of loop plant, but also in the case of other network elements, such as switching, that have traditionally been subject to allocations based on traffic sensitivity.⁴³ Usage measurements contribute little precision while requiring enormous administrative burdens. Conversely, the use of a fixed cost allocator would provide administrative convenience, a goal the Commission has repeatedly considered in cost allocation proceedings.⁴⁴ For example, in approving an AT&T common cost allocation

⁴² In recommending a specific ratio, NCTA is guided by the attached economic analysis performed by Dr. Johnson. There of course is room to debate the judgment made in NCTA's proposal. It could not be otherwise. That, after all, is one of the principal implications flowing from the fact that common cost allocations are arbitrary. However, NCTA urges the Commission to preempt the debate on the numbers by recognizing that this is an exercise of estimates and approximations and, more importantly, that the allocation selected is derived from policy goals, not from microscopic observation of the costs.

⁴³ See Johnson, Allocating Common Costs, at 8 ("The extreme difficulty of obtaining . . . disaggregated data, going beyond local loops . . . suggests that the Commission might do best simply to use the same fixed factor allocations as for local loop investment.").

⁴⁴ See, e.g., Investigation of Special Access Tariffs of Local Exchange Carriers, CC Docket No. 85-166, Phase I, Memorandum Opinion and Order, at ¶ 102 (released January 24, 1986)("[C]arriers . . . frequently must employ common cost allocation . . . which [is] neither given to a high degree of precision nor capable of being analyzed or audited in the conventional sense. This is due, in part, to the fact that considerations other than costs -- market demand, customer and administrative convenience -- must be accounted for in the

method, the Commission stated, "we consider this a reasonable approach, given the disproportion between administrative burdens of pursuing a still more granular methodology and the limited practical benefits of the refinement that might ensue."⁴⁵ NCTA urges a similar approach in this proceeding.

Finally, NCTA urges the Commission to use the same fixed factor on a national basis. Once again, the potential administrative burdens of tailoring fixed factors to specific LECs or regions mandate a national method. In amending its rules for allocation of non-traffic sensitive and traffic sensitive costs, the Commission used a nationwide approximation of the average Subscriber Plant Factor to set the basic interstate allocation.⁴⁶ Similarly in this proceeding, for purposes of administrative ease and uniformity of application, the Commission should require LECs to allocate common costs using the same fixed factor nationwide.

B. The Commission Should Compare Fixed Factors to the Stand-Alone Costs of Developing a State-of-the-Art Telephone Network.

A 75% cost allocation to video services will not necessarily eliminate cross-subsidization; it merely affords a measure of protection (while simultaneously affording the major benefit of ease of administration). If the Commission wishes to spare telephone ratepayers the

rate development process. . . . [W]e look to determine whether the proposed ratemaking methodology is reasonable, not whether it mirrors perfectly the cost of providing the individual services in question.").

⁴⁵ AT&T Communications; Tariff F.C.C. Nos. 9, 10 and 11, 3 F.C.C.R. 4579, 4583 at ¶ 32 (1988); see also American Civil Liberties Union v. FCC, 823 F.2d 1554, 1572 (D.C. Cir. 1987) ("The FCC properly considered ease of application in selecting its standard."), cert. denied, 485 U.S. 959 (1988).

⁴⁶ See Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, 96 FCC 2d 781, 787, at ¶ 11 (1984).

burden of cross subsidy in every case, it must be concerned with whether costs allocated on the basis of direct assignment and fixed factors exceed the stand-alone costs of providing a state-of-the-art telephone system using, for example, digital loop carriers to provide service.⁴⁷

Using the stand-alone costs of a sophisticated telephone network will enable the Commission to measure the incremental costs of providing video services over an integrated network. The stand-alone costs of telephony can be used as a ceiling or constraining influence to ensure that no more costs are allocated to the telephone side of the network than would be the case in the absence of an integrated network. By combining a fixed factor for allocation of common costs and using the stand-alone costs of a digital loop carrier provision of telephony as a ceiling for allocation of costs to telephone service, the Commission can protect against the danger of cross-subsidization.⁴⁸ Moreover, it is important that the cost allocation to telephony fall significantly below that ceiling in order to allow telephone ratepayers to share appropriately in the benefits of scope economies.⁴⁹

⁴⁷ See, e.g., Johnson, Allocating Common Costs, at 8 ("Of central importance is the need to monitor the stand-alone costs of telephone networks in relation to integrated network costs, to ensure that cost allocations to telephony fall below stand-alone costs as the way to avoid cross-subsidy and to promote the sharing of benefits from scope economies.").

⁴⁸ See id., at 4-5 ("[Telephone ratepayers] would be . . . burdened [with cross-subsidies] only if . . . the cost assigned to telephony exceeds the stand-alone cost of the telephone network.").

⁴⁹ See id., at 5 ("Telephone ratepayers . . . would share the benefits of scope economies if the cost assigned to video exceeds video incremental cost.").

The Commission will need to continually track the relationship between stand-alone costs of telephony and the development of an integrated network.⁵⁰ If the disparity widens, the Commission will need to adjust its cost allocation factors. However, properly administered, stand-alone cost comparisons undertaken in conjunction with a calculation of scope economies will ensure that expenses in excess of those required to provide the most sophisticated telephone network will not be borne by telephone ratepayers.

C. A Seventy-Five Percent Allocation of Costs to Video Services Is Necessary to Ensure that Local Telephone Ratepayers Share in Scope Economies

In its Notice, the Commission expressed its policy judgment that "telephone ratepayers are entitled to at least some of the benefit of the economy of scope between telephony and competitive services."⁵¹ To realize this policy goal, the Commission should adopt the NCTA proposal to allocate 75 percent of common costs to video services. A smaller fixed factor percentage would decrease the likelihood that telephone ratepayers would share in the benefits of scope economies.

In his attached analysis, Dr. Johnson uses the data supplied by Bell Atlantic in its application to provide video dialtone service in Dover Township to illustrate that 97 percent of common costs of loop plant would have to be allocated to video in order to prevent cross-subsidization of competitive services by local ratepayers.⁵² Dr. Johnson further determines that

⁵⁰ See id., at 2-3 ("Especially important in determining appropriate changes in the allocation factor over time, the Commission must monitor the relationship between the costs of stand-alone telephone and video networks and the costs of integrated systems.").

⁵¹ Cost Allocation Notice, at 12, ¶ 23.

⁵² See Johnson, Allocating Common Costs, at 9, Table 1.